FrontLine Research Paper

Does size matter? In US LBO, yes.

US leveraged buy-out (LBO) funds are the largest pool of private market investment opportunities globally. They are a staple of fund investment portfolios and are often the leading category for portfolio construction. Not surprisingly, these funds are among the most studied and monitored. Findings are widely commented upon but are often focused on mega and large funds, resulting in generalisations that could be misleading. Multiple reasons could explain this focus, chief among them a relative lack of information.

Thanks to the high quality and granularity of the data provided by eFront Insight, it is possible to explore further the behavior of US LBO funds. This issue of FrontLine will focus on cash flows, which are immune to subjective evaluation biases. American funds also offer a particularly solid ground for an analysis as they invest and report in US dollar, hence eliminating biases from foreign exchange.

Small buy-out funds deploy capital rapidly and reinvest a significantly higher proportion of fund sizes.

To draw stronger conclusions, we will focus on vintage years up to 2009, since they are fully or largely realized. The sample is divided between mega, large, medium and small buyout funds [1]. As usual in private equity, some statistical outliers can skew the results. Some filters were applied, which means that

[1] The funds are classified by the target capitalization of the companies in which the fund is seeking to invest with.

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the vintage years in each sub-sample are not strictly equivalent. With this limitation in mind, it is possible to analyse how US LBO funds evolve in aggregate over time.

As deal size increases, the propensity of the fund manager to recycle distributions decreases.

Looking at contributions

Regardless of their size, US LBO funds share some common features. By Year 5, they are all fully invested. They all have a cumulated paid-in above 100% of the fund size. Fund managers recycle early distributions and reinvest them to compensate for the weight of costs and fees on performance. The shape of the curve is fairly similar, although the deployment is faster at the smaller end of the deal sizes and slower at the higher end.

Some notable differences appear as well. The most visible one is the scale of reinvestments. Counter-intuitively, small buy-out funds deploy capital at a fast clip and reinvest a significantly higher proportion of fund sizes than other funds. They also continue to invest significantly until Year 8. What could explain this unusual feature?

Usual investment periods last five to six years for closed-end LBO funds. After that period, new investments are usually not authorized by the fund regulations. However, fund managers can reinvest in existing deals, notably to execute buy-and-build strategies. This consists in building on a first acquisition (the "platform") and acquire additional companies (the "add-ons") to aggregate them with the initial acquisition. A manager executing a buy-and-build continues to invest well beyond the investment period.

It is more difficult to explain the particularly high level of paid-in to committed capital. The usual explanation is that early distributions are recycled to compensate for management fees and other costs. This allows the fund manager to effectively invest up to 100% of the fund size. However, management fees and costs usually account for 25 to 30% of the size of a fund. According to Figure 1, managers deploy more than double of that.

A possible theoretical explanation is that fund managers recycle capital not only to compensate for the weight of fees and costs but also to make new investments as long as they are in the investment period. This explanation is supported by the fact that managers of small LBO funds distribute more capital and faster (Fig. 2).

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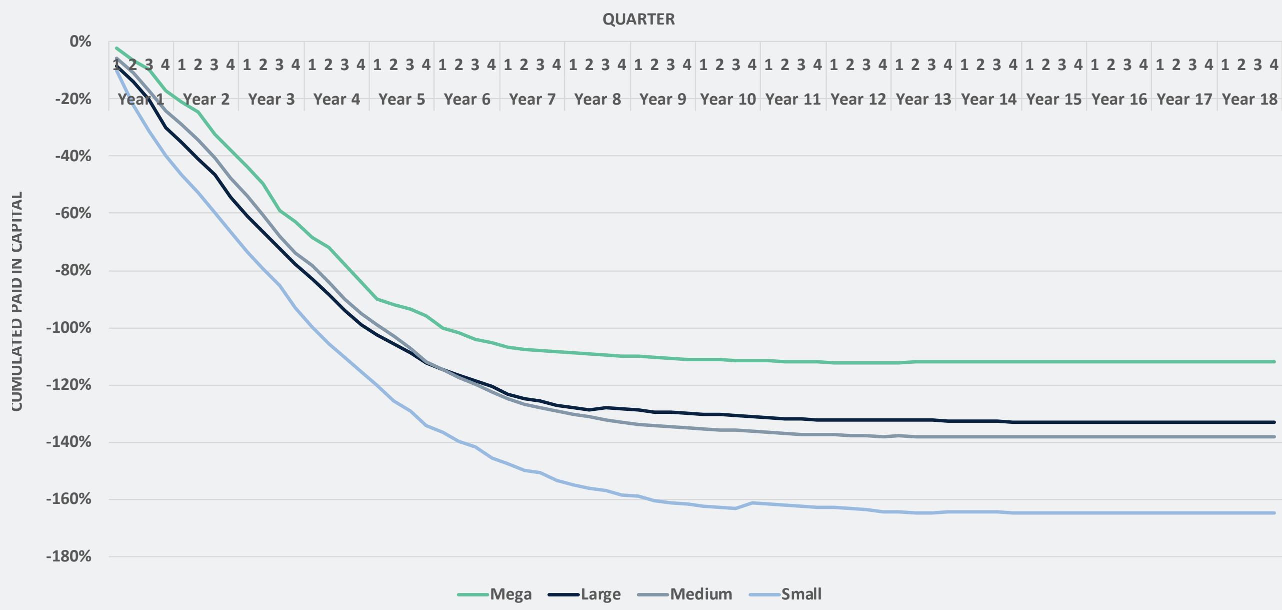
Figure 1 – Cumulated contributions of US LBO funds, by size of deals



Source: eFront Insight, as of Q4, 2018.

As deal size increases, the propensity of the fund manager to recycle distributions decreases. Medium and large LBO funds are however fairly close. Mega LBO funds do not seem to recycle intensively early distributions, though they still compensate for fees and costs with an average paid-in to committed capital ratio of 112%.

Some anomalies can be noted, such as bumps materializing negative contributions in Year 8 for large LBO funds and in Year 10 for small LBO funds. These could be contributions motivated by attempts to do add-on acquisitions which did not materialize. They are particularly visible because most of the funds are fairly inactive in terms of contributions at this stage of the life of the funds.

A word on distributions

Distributions follow a common pattern, regardless of the size of deals (Fig. 2). They start in earnest in Year 3, accelerate noticeably for Year 5 on. They slow down from Year 12 for mega LBO funds, from Year 13 for large LBO funds, Year 14 for small and medium LBO funds. This is a logical consequence of the pattern of contributions. As small to large LBO funds continue to invest well beyond the usual investment period, they also hold assets longer and distribute well beyond the usual 10 years of fund lifespan.

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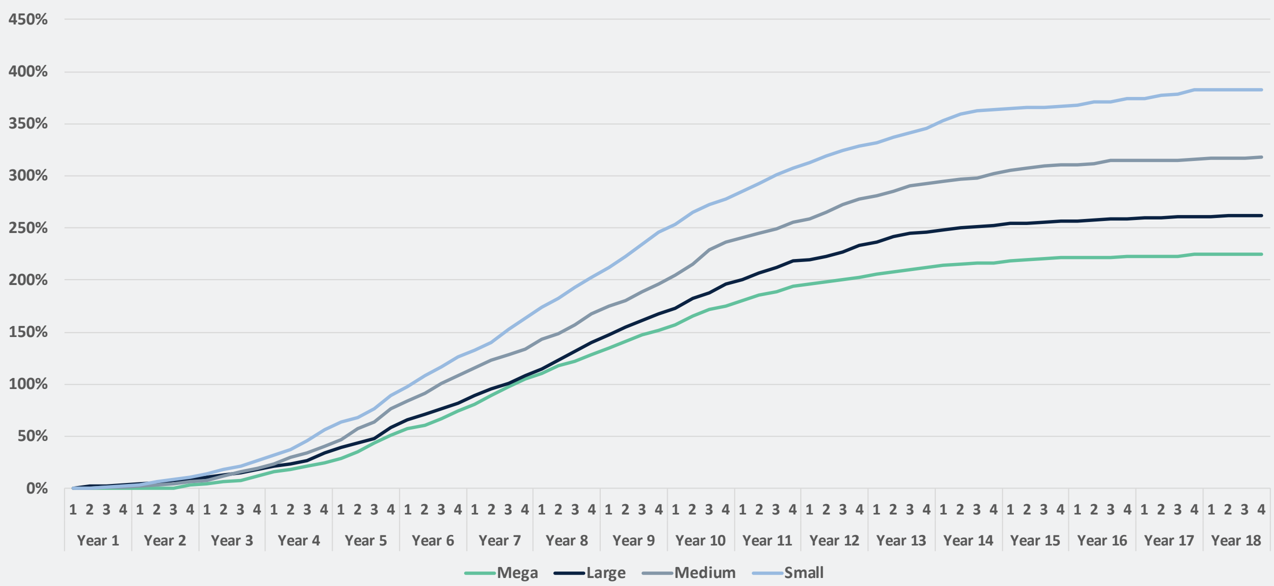
Figure 2 – Cumulated distributions of US LBO funds, by size of deals



Source: eFront Insight, as of Q4, 2018.

Some differences also appear clearly. Small LBO funds distribute significantly earlier than medium, large and mega LBO funds respectively. This is logical, as these distributions are then recycled into contributions as explained above. This is an important piece of information. Indeed, it could be tempting to conclude that small and medium-size LBO funds are more attractive than large and mega LBO funds when looking only at distributions (Fig. 2).

However, knowing that the contributions are significantly higher, and capital might be significantly recycled, the overall picture is more nuanced (Fig. 3). Indeed, the plotted J-curves provide an interesting picture, but the fact that contributions and distributions partially compensate one another hides the more detailed conclusions that a granular analysis provides.

Small LBO funds return capital faster and appear to be more profitable. Medium LBO funds have the shallowest bottom of the J-curve and come second best in terms of performance. Large LBO funds are probably the most representative J-curve, as they reach the net bottom in Year 4 and recover regularly. The only exception is that they are the slowest to cross the break-even line, in Year 8 only, while the other strategies do in Year 7. Mega LBO funds reach the bottom on a net basis in Year 5 and appear to be the poorest performers. However, there might be more than meets the eye.

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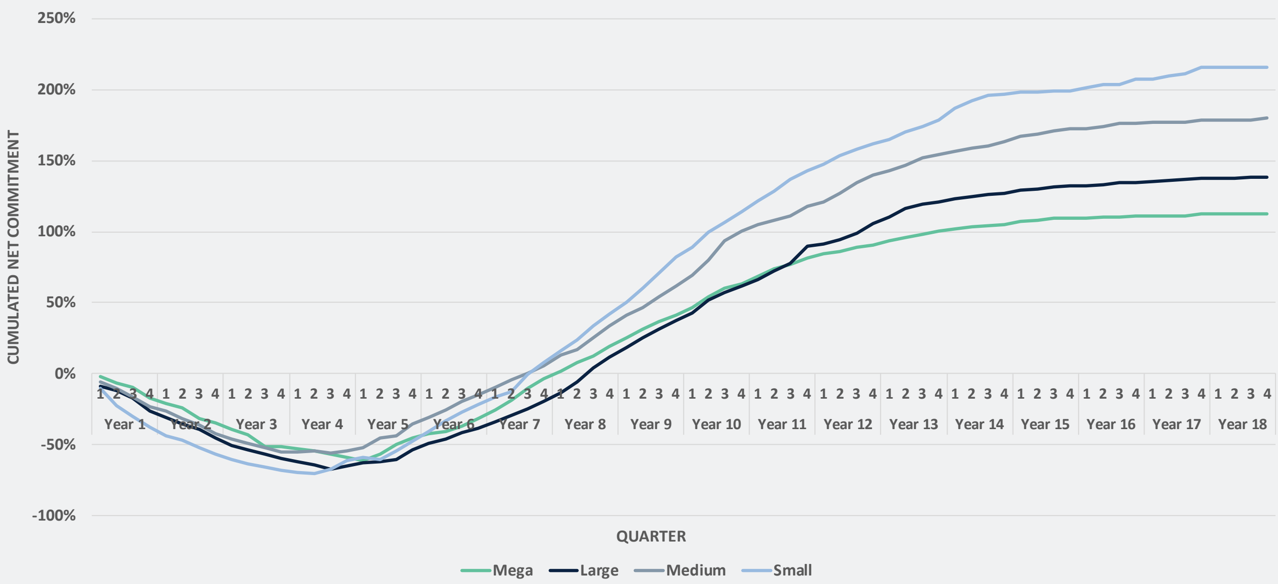
Figure 3 – Cumulated cash-flows of US LBO funds, by size of deals



Source: eFront Insight, as of Q4, 2018.

Indeed, if mega LBO funds seem less profitable, they also have attributes which might make them appear as less risky. In particular, they provide predictable streams of cash flows. Contributions are essentially limited to the first five years of activity of the fund, distributions largely done by Year 10 and mostly finished by Year 12. Given this, patient investors that are willing to handle more fluctuations in terms of capital inflows and outflows, might be interested in looking at small LBO funds.

Small LBO funds distribute significantly much earlier than medium, large and mega LBO funds.

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Conclusion

The debate surrounding the performance of US LBO funds and its expected evolution can at times hide a more nuanced and granular perspective. Looking at the funds according to the size of the transactions they operate at introduces an interesting perspective. Notably, it is clear that mega LBO funds are not representative of the overall LBO sector. Cash flow patterns uncover a wide diversity of activities, and counter-intuitively show that small LBO funds are extremely active in recycling capital and are likely to operate significant buy-and-build strategies. This shifts the debate to investor preferences and their perception of how adequate the return profile of each category of LBO funds is. Breaking down LBO funds in categories also hints at different risk profiles. This supports a more balanced view of the merits of each category of LBO funds.

Mega LBO funds seem less profitable but have attributes making them appear as less risky

Note

The aim of this newsletter is to provide readers with elements of analysis and understanding of the private finance universe, based only on data collected by eFront Insight. It does not intend to draw any definitive conclusion, nor judge the performance of fund managers. By providing a guided reasoning, FrontLine hopes to contribute to the overall progress of understanding of the asset class in a short monthly format, with all the limits that this entails.

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